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July 11, 2001

COMMENT

BY HAND

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Ms. Jean Webb
Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: "Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume; Applications of the Definition of Narrow-Based Security Index" (File No. 57-11-01)

Dear Mr. Katz and Ms. Webb:

This letter sets forth the comments of the U.S. Securities Markets Coalition¹ on certain proposed rules, issued by the SEC and the CFTC (collectively, "the Commissions") in the above-referenced Release, regarding the definition of "narrow-based security index" as adopted in the Commodity Futures Modernization Act of 2000 ("the CFMA"). The Coalition's comments address the proposed rules that preserve the status of a security index as broad-based or narrow-based, respectively, when the index would no longer retain such status under the statutory definition enacted in the CFMA and embodied in section 3(a)(55) of the Exchange Act and section 1a(25) of the CEA.

Our comments are directed to the tax implications of the proposed rules. The proposed rules have tax consequences because the tax treatment of an option or futures contract on a security index depends on whether the index is broad-based or narrow-based. Options and futures on broad-based security indexes receive so-called "60/40" tax treatment, which is generally viewed as favorable, while options and futures on narrow-based security indexes do not receive this treatment. For this purpose, the tax law looks to the definition of "narrow-based security index" as contained in section 3(a)(55) of the Exchange Act.

¹ The members of the Coalition are the American Stock Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, the Chicago Stock Exchange, the Cincinnati Stock Exchange, the NASDAQ Stock Market, the Options Clearing Corporation, the Pacific Stock Exchange, and the Philadelphia Stock Exchange.

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Our purpose in presenting these comments is to ensure that the Commissions are aware of the tax consequences that flow from the proposed rules and to encourage the Commissions to keep these tax implications in mind in considering possible modifications to the rules before issuing them in final form. The most significant implications are as follows:

1. As the proposed rules are currently drafted, an option on a broad-based security index that becomes narrow-based will not receive the benefit of the status preservation rules for tax purposes unless there is also a futures contract on the same index. As a result, where there is no corresponding futures contract, a broad-based security index option that becomes narrow-based will apparently be treated as narrow-based for tax purposes on the first day the index satisfies the statutory definition of a narrow-based security index.
2. The CFTC's proposed status preservation rule for narrow-based security indexes that would otherwise become broad-based will not apply for tax purposes because the tax definition of a narrow-based security index is tied to the definition in the Exchange Act rather than the CEA. As a result, both options and futures on narrow-based security indexes that become broad-based will apparently be treated for tax purposes as broad-based on the first day the index no longer satisfies the statutory definition of a narrow-based security index.
3. If the status preservation rules are not applicable, the status of an index option or future as broad-based or narrow-based for tax purposes could change back and forth, creating uncertainty and confusion for traders and investors, with a resulting disruption of the markets.

We urge the Commissions to formulate appropriate status preservation rules so as to provide stability to the markets by minimizing the tax implications, and associated market disruption, that would otherwise be associated with changes in the status of an equity index.

I. BACKGROUND

A. The CFMA

The CFMA permits trading of futures on narrow-based security indexes. Futures on narrow-based security indexes are subject to joint regulation by the SEC and CFTC and can trade on boards of trade, securities exchanges or derivatives transaction execution facilities

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("DTEFs"). In contrast, futures on broad-based security indexes are subject to regulation only by the CFTC and cannot be traded on securities exchanges.²

The CFMA contains an objective definition of a narrow-based security index, which did not exist under the Shad-Johnson Accord. The CFMA's general definition of narrow-based security index includes a series of quantitative tests tied to the composition of the index. If any of these tests are met, the index is a narrow-based security index unless one (or more) of a series of exceptions applies. Any security index that is not narrow-based under this provision is considered broad-based.

The exceptions to the general definition of a narrow-based security index include a "status preservation rule" that preserves broad-based status for indexes that have previously been broad-based but that become narrow-based under the general definition. This rule is designed to mitigate the effects of fluctuations within the index that could otherwise cause a future on the index to become subject to joint SEC/CFTC jurisdiction as a future on a narrow-based security index.

The statutory status preservation rule provides that an index that falls within the general definition of a narrow-based security index will nonetheless not be narrow-based if:

1. a futures contract traded on the index for at least 30 days while the index was broad-based, and
2. the index has been a narrow-based security index for no more than 45 business days over three consecutive calendar months.³

The statute further provides that if a security index is narrow-based solely because it was narrow-based for more than 45 business days over three consecutive calendar months, it is not a narrow-based security index for the three following calendar months.⁴

² Unlike index futures, index options are regulated solely by the SEC. The SEC's regulation of index options is not affected by whether the index is broad-based or narrow-based under the definitions created by the CFMA. The SEC has separate guidelines for determining whether an index is broad-based or narrow-based for regulatory purposes, such as margin requirements and position limits. The Chicago Board Options Exchange has submitted a comment letter urging the SEC to modify its guidelines to conform to the definition in the CFMA.

³ See § 3(a)(55)(C)(iii) of the Exchange Act.

⁴ See § 3(a)(55)(E) of the Exchange Act. The Preamble to the proposed rules describes this provision as a "statutory grace period of three months before the futures contract becomes a security future." See Preamble at p. 13. While preventing such a future from becoming a securities future during the grace period is the regulatory effect, it is important for tax purposes that it is the status of the index as a broad-based security index that is preserved. Merely (continued...)

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B. The Proposed Rules

1. **Jointly Proposed Rule.** -- The SEC and CFTC have proposed a rule that would expand the statutory status preservation rule for broad-based security indexes. Under the proposed rule, an index that has been broad-based for 6 months will be treated as broad-based even if it becomes narrow-based under the general definition during the first 30 days in which a futures contract trades on the index. In this situation, the index will not become narrow-based unless it is narrow-based for more than 45 days during three consecutive calendar months. In addition, if the index is narrow-based for more than 45 days during three consecutive calendar months, it will continue to be treated as broad-based for the following three calendar months. This proposed rule essentially parallels the statutory status preservation rule except that it addresses indexes that become narrow-based under the general definition during the first 30 days in which a futures contract trades on the index.

2. **CFTC Proposed Rule.** -- While the CFMA adopted a rule to preserve the status of broad-based security indexes, it did not include a comparable rule to preserve the status of narrow-based security indexes. Thus, if an index future that has been narrow-based becomes broad-based, the future would apparently cease to be a securities future immediately. As a result, the product would become subject to regulation solely by the CFTC and could not be traded on a securities exchange.

The CFTC has proposed a rule under the CEA to address this situation.⁵ The proposed rule would provide that an index that is narrow-based and becomes broad-based for no more than 45 days over three consecutive calendar months will be treated as narrow-based. In addition, if an index that was narrow-based becomes broad-based for more than 45 days over three consecutive calendar months, it will nonetheless continue to be treated as narrow-based for the following three calendar months. The structure of the proposed rule thus mimics the status preservation rule for broad-based indexes that become narrow-based indexes. Although the CFTC plainly proposed this rule to address security indexes on which futures are traded, the language of the proposed rule does not by its terms require that a futures contract on the index be in existence. As explained below, formulating a status preservation rule as the CFTC has done, *i.e.*, without tying the rule to the existence of a futures contract on the index, is critical to obtaining stability in the tax treatment of index options.

providing that the futures contract does not become a security future would not preserve the 60/40 tax status of an option on the same index.

⁵ Proposed Rule 41.14. Apart from the tax considerations addressed in this letter, this proposed rule should be modified to provide an orderly transition for regulatory purposes when a narrow-based security index future ceases to be narrow-based.

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C. Tax Treatment of Index Options and Futures

Prior to the enactment of the CFMA, index futures were limited to broad-based security indexes, and all index futures contracts traded on domestic boards of trades received 60/40 tax treatment. Index options were treated as broad-based for tax purposes -- and thus entitled to 60/40 treatment -- if any of three conditions were satisfied:

1. The CFTC had authorized trading of a futures contract on the index;
2. The IRS determined that the requirements for a CFTC authorization of a futures contract on the index were satisfied; or
3. The SEC had determined that the index was broad-based for regulatory purposes.⁶

These rules were designed to achieve tax parity between options and futures on broad-based security indices.

The enactment of the CFMA changed the regulatory landscape and thus necessitated a modification of the associated tax rules. Tax legislation enacted contemporaneously with the CFMA amended existing tax law in order to preserve the policy of providing equivalent tax treatment for index options and futures.⁷ Under the amended tax law, options and futures on broad-based security indexes receive 60/40 treatment, and options and futures on narrow-based security indexes do not. For this purpose, a narrow-based security index is an index that is a "narrow-based security index" as defined in section 3(a)(55) of the Exchange Act. See I.R.C. §§ 1256(g)(6)(B), 1256(g)(9) and 1234B(c). Thus, the tax rules "piggy-back" on the CFMA's definition of narrow-based security index, including the exceptions thereto, as embodied in section 3(a)(55) of the Exchange Act.

II. TAX IMPLICATIONS OF JOINTLY PROPOSED RULE PRESERVING THE STATUS OF BROAD-BASED SECURITY INDEXES

The CFMA's general definition of a narrow-based security index, as incorporated by reference into the tax law, applies equally to index options and index futures. Thus, for example, if an index has more than nine component securities and is not otherwise narrow-based

⁶ See I.R.C. § 1256(g)(6), prior to amendment by the 2000 legislation; Rev. Rul. 94-63, 1994-2 C.B. 188.

⁷ These changes were needed because of the repeal of Shad-Johnson. For example, now that futures on narrow-based security indexes are permitted under the CFMA, the tax rules can no longer treat an index as broad-based merely because the CFTC has authorized trading of a future on the index.

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under the general definition provided in the CFMA, a listed option on the index will receive 60/40 treatment, as will a futures contract on the index. Similarly, if the index is narrow-based under the general definition, and none of the exceptions apply, neither an option on the index nor a future on the index will receive 60/40 treatment. In contrast, the status preservation rules, as included in the statute and expanded by the proposed joint SEC/CFTC rule, apply only if there is a futures contract on the index. As a result, the tax status of an index option that becomes narrow-based under the general definition depends upon whether there is a corresponding futures contract on the same index.

If a futures contract is traded on the same index, and the index remains broad-based under the status preservation rules, then an option on the index will remain broad-based just as long as the futures contract on the index remains broad-based. However, if no futures contract exists, then an option on an index that was previously broad-based and becomes narrow-based under the general definition will apparently become a narrow-based security index option for tax purposes on the first day the index is narrow-based. Moreover, the tax status of the index option could change on a daily basis as the market capitalizations of the component stocks change.

Example: A securities exchange trades an option on a utility index composed of 12 stocks. The index has been broad-based continuously over the past six months. However, because of developments in the utility industry, the average daily trading volume of the lowest weighted stocks, comprising 25% of the index, falls below \$50,000,000. As a result, the index is now narrow-based unless one of the status preservation rules applies.

If a futures contract on the index was in existence for at least 30 days before the index became narrow-based, then the index will not be treated as narrow-based unless it is narrow-based for at least 45 days over three consecutive calendar months. Even if a futures contract had existed for less than 30 days while the index was broad-based, the index would benefit from the status preservation rule proposed by the SEC and CFTC because it had been broad-based for the previous 6 months. As a result of these status preservation rules, which are tied to the existence of the futures contract, the index options would also continue to have broad-based status for tax purposes.

However, if no futures contract exists on the index, these status preservation rules would not apply. As a result, the index option would become narrow-based on the first day it is narrow-based under the general definition. In addition, if trading volume in the lowest weighted component stocks increased again, the index could immediately become broad-based once that volume

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exceeded \$50 million. One could envision a scenario in which the average daily trading volume of the lowest-weighted securities could oscillate back and forth around the \$50 million level based on the 6-month trailing average approach outlined in the proposed rules.

III. TAX IMPLICATIONS OF PROPOSED CFTC RULE PRESERVING STATUS OF NARROW-BASED SECURITY INDEXES

As noted above, the CFTC has proposed a rule that would preserve the narrow-based status of an index in essentially the same way as the statute and the jointly proposed SEC/CFTC rule would preserve the status of broad-based security indexes. The CFTC's proposed rule is problematic from a tax perspective because the tax definition of a narrow-based security index refers to the definition in section 3(a)(55) of the Exchange Act, not the definition in the CEA. As a result, a rule proposed solely by the CFTC (as distinguished from the jointly proposed rules that would be implemented under both the Exchange Act and the CEA) would not appear to have any operative effect for tax purposes. This lack of tax effect applies equally to index futures and index options. Thus, while the CFTC's proposed rule may preserve the regulatory status of a futures contract on a narrow-based security index that becomes broad-based, it would not cause the tax status of the future, or an option on the same index, to be preserved. As a result, the future or option would apparently become broad-based for tax purposes on the first day that the index is no longer narrow-based under the general definition of a narrow-based security index in section 3(a)(55) of the Exchange Act.

The CFTC's proposed rule applies to an index without regard to whether a futures contract is traded on the index. In other words, although the statutory status preservation rule and the additional status preservation rule proposed jointly by the SEC/CFTC apply only if there is a futures contract on the index, the CFTC's proposed rule is not so constrained. The approach reflected in the proposed CFTC rule, if adopted by the SEC under section 3(a)(55) of the Exchange Act, has the potential to be helpful from a tax perspective because it could provide some stability to the tax status of an index option that might otherwise convert from narrow-based to broad-based even if there is no futures contract on the index.

IV. RECOMMENDATIONS

The Coalition urges the Commissions to consider the tax implications of their proposed rules before issuing them in final form. We believe that, to the maximum extent possible, the Commissions should craft the rules so as to minimize the confusion and market disruption that could result if the tax status of an index option or future as broad-based or narrow-based were potentially subject to frequent change. This goal can be achieved (i) if the SEC adopts the appropriate rules under section 3(a)(55) of the Exchange Act, which determines the status of the index for tax purposes, and (ii) if the rules are adopted following the approach of Proposed Rule 41.14, which does not include the existence of a futures contract as part of the

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rule preserving the status of a narrow-based security index that would otherwise become broad-based.

The Coalition appreciates the opportunity to comment on the proposed rules and would further welcome the opportunity to work with the Commissions to fashion appropriate rules in light of Congress's decision to tie the tax status of index options and futures to the definition of "narrow-based security index" in section 3(a)(55) of the Exchange Act. If you have any questions, please contact the undersigned at (202) 662-5300.

Sincerely,



William M. Paul

cc: Securities and Exchange Commission
Acting Chairman Laura S. Unger
Commissioner Issac C. Hunt, Jr.
Annette L. Nazareth
Robert L.D. Colby
Elizabeth King

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